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Eastern Europe: Economic Problems and Prospects [redacted]

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An Intelligence Assessment

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March 1982

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Eastern Europe: Economic Problems and Prospects [redacted] 25X1

An Intelligence Assessment

Information available as of 15 January 1982 has been used in the preparation of this report.

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Eastern Europe: Economic Problems and Prospects [redacted]

Key Judgments

The performance of the East European economies has deteriorated sharply in recent years. GNP growth has gone from nearly 5 percent per annum in the first half of the 1970s to virtual stagnation or worse since 1978, and some of the countries face serious external financing problems. Slower growth can be attributed in part to stabilization programs designed to rein in rapidly growing hard currency debt and to unfavorable developments in Western markets. Eastern Europe's problems, however, are rooted primarily in the chronic distortions and inefficiencies of centralized economic planning and clumsy management.

The East European regimes are now paying the price for the ambitious and poorly conceived investment programs that they financed in large part with hard currency credits and for their failure, for the most part, to reform their outdated systems of economic management. For a time, sizable inflows of new Western credits permitted large-scale imports of Western equipment, grain, and other goods, helping to paper over economic shortcomings. But poor investment decisions and the rigidities of their command economies thwarted the translation of Western technology into improved industrial productivity and competitiveness.

Eastern Europe's transition to slow growth would have been even more abrupt if Moscow had not continued to increase supplies of energy and raw materials at concessionary prices and had not granted long-term credits to help Eastern Europe cope with rising trade imbalances with the USSR.

Over the next few years, economic performance and living standards will at best stagnate in Eastern Europe, aggravating the danger of political instability. The region will be hurt by slowing deliveries of Soviet energy and raw materials, worsening terms of trade with both the USSR and the West, and reduced availability of Western credit. Investment rates will continue to fall in response to hard currency shortages and decisions to pay more attention to consumption. Economic performance will also suffer from a further slowdown in labor force growth and persistent problems with productivity. With the possible exception of Hungary, no East European regime seems likely to implement the reforms needed to correct basic ills of its planning and management system.

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Economic Performance in Perspective

Until the late 1970s, several factors combined to give the East European economies a reasonably good growth record:

- Rapid expansion of the industrial labor force.
- Ability to maintain a high level of investment in heavy industry without serious constraints from competing consumer demands.
- Buoyant growth of Western markets and relatively stable terms of trade with the West.
- Ever-increasing supplies of Soviet raw materials and energy provided at attractive prices.
- A guaranteed market for East European manufactured goods within the Council for Mutual Economic Assistance (CEMA). [redacted]

Growth rates peaked in the early 1970s as the East Europeans turned to Western credits to help sustain levels of investment and support rising consumption. The East European governments realized that their economies could benefit from an infusion of Western technology. Eastern Europe's need for hard currency credits and goods coincided with Western interest in promoting political detente through expanded trade. Western governments eagerly offered credit guarantees to open up new markets for their capital goods manufacturers and food exporters. The massive surge in Euromarket liquidity stemming from the recycling of OPEC funds provided even greater credit sources for the East Europeans. [redacted]

About the same time, some East European economists argued that a revamping of planning and management was needed because the Stalinist command economy model had become outmoded. They pointed out that with resource supplies tightening, growth strategy should be based on increasing the productivity rather than the quantity of inputs. They also argued that arbitrary prices, state subsidies, politically motivated investment decisions, and full-employment guarantees would prove increasingly inefficient and detrimental to rational resource allocation. For the most part, however, the cautious East European regimes did little more than tinker with their economic mechanisms. Only Hungary pursued a major decentralization program based on greater use of market-oriented regulators. [redacted] 25

Problems Multiply

The forward momentum of the East European economies dissipated quickly after the mid-1970s. Hard currency debt rose much more rapidly than planned as Western inflation boosted import prices and recession in the West added to East European problems in marketing exports. Despite ambitious and costly modernization programs, the gains in productivity and competitiveness of East European industry fell far short of expectations. Poor management decisions wasted resources on unpromising investments, while critical sectors such as agriculture were neglected. Chronic neglect of infrastructure resulted in energy and transportation bottlenecks that hampered industrial production. Overly bureaucratic management lacked the flexibility needed to cope with the increasingly complex problems. [redacted] 25

Government agricultural policies and increasing price subsidies for consumers led to growing imbalance between the supply of and the demand for meat and other foods. Hard currency problems increased as greater reliance was put on imports of Western grain. Most governments pursued policies of low investment in agriculture and minimum incentives for farmers in order to provide maximum resources for industrial development. Despite large-scale imports, consumer discontent rose, most notably in Poland, as the availability of goods failed to keep pace with rising expectations. [redacted] 25

Worried about their rising hard currency debt, most East European countries began to retrench in a bid to raise exports to the West while cutting purchases of

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Table 1 Percent

Eastern Europe: GNP Growth Rates

	1966-70	1971-75	1976-78	1979	1980	1981 [a]
Eastern Europe	3.7	4.8	3.1	1.3	1.3	−2.5
Bulgaria	4.7	4.5	1.2	4.1	−0.2	3.0
Czechoslovakia	3.5	3.4	2.5	1.1	1.9	0.5
East Germany	3.2	3.5	2.2	2.9	2.6	2.6
Hungary	3.1	3.4	2.7	0.2	0.3	1.0
Poland	3.8	6.6	2.5	−1.9	−2.6	−14.0
Romania	4.6	6.2	6.6	4.3	1.0	1.0

[a] Estimated.

[redacted]

Western goods. But in some cases (Poland and Romania), restraint measures came too late to prevent serious financial problems or were applied ineptly and further impeded growth. Poland's deteriorating position lent particular urgency to the efforts of the other countries to bring their external accounts under control. While Bulgaria, Hungary, and Czechoslovakia managed to stabilize their debt positions, the cutbacks—coupled with fundamental economic weaknesses—depressed growth throughout Eastern Europe to postwar lows after 1978. [redacted]

The slowdown in growth would have been even steeper except for Moscow's willingness—prompted by the specter of growing instability in Eastern Europe—to shoulder some of the adjustment burden. Despite its own production problems and opportunities to sell in the West at skyrocketing world market prices, the USSR continued to supply growing quantities of energy and raw materials on favorable terms. The CEMA pricing mechanism caused increases in the prices of Soviet exports to lag well behind world trends. Moscow further softened the adjustment process by extending sizable long-term credits to cover Eastern Europe's rapidly mounting trade deficits with the USSR. [redacted]

Recent Trends Show Little Improvement

In 1981 Bulgaria and Hungary posted some improvement in their economic growth rates, while the GDR maintained relatively strong growth. Performance remained dismal in Romania, and Czechoslovakia suffered a further slowdown (see table 1). Living standards stagnated in Hungary and Czechoslovakia and declined in Romania. Economic performance in these countries was far better, however, than in Poland, where GNP fell by 14 percent (see table 1). [redacted]

Although financial stringencies forced reductions in Poland's and Romania's current account deficits, worsening terms of trade and faster growth in a few countries pushed Eastern Europe's overall balance of payments even deeper into the red. The region's debt grew to over $60 billion by the end of 1981 (see table 2). Hard currency debt has become so large that over half of earnings from exports to the West must go for interest and principal repayments. Poland was involved in debt rescheduling negotiations throughout 1981, and Romania reached a tentative agreement with Western banks to reschedule over $2 billion of debts falling due in 1982. All the countries will face serious adjustment problems since banks and other creditors have been adopting more cautious lending policies as a result of increasing economic and political concern over CEMA creditworthiness. [redacted]

[1] A forthcoming Intelligence Assessment will discuss in more detail the impact of cutbacks in Western lending on Eastern Europe. [redacted]

Table 2 Billions of Current Dollars

Eastern Europe: Balance of Payments With Non-Communist Countries

	Trade Account	Current Account	End-Year Net Debt	Debt Service Ratio (percent)
Bulgaria				
1971	−0.1	0.1	1	45
1975	−0.6	−0.7	3	33
1979	0.7	0.5	4	38
1980 [a]	1.0	0.9	3	32
1981 [a]	0.6	0.6	2	36
Czechoslovakia				
1971	0.0	−0.2	0	9
1975	−0.1	−0.3	1	14
1979	−0.8	−0.9	4	22
1980 [a]	0.0	−0.4	4	18
1981 [a]	0.4	−0.2	4	22
East Germany				
1971	−0.2	−0.3	1	18
1975	−1.1	−1.2	5	25
1979	−1.5	−1.5	10	54
1980 [a]	−1.9	−1.9	12	55
1981 [a]	−1.4	−1.9	13	69
Hungary				
1971	−0.3	−0.3	1	15
1975	−0.7	−1.0	3	19
1979	−0.7	−1.1	8	37
1980 [a]	0.3	−0.5	8	30
1981 [a]	0.4	−0.6	8	37
Poland				
1971	0.1	0.2	1	20
1975	−2.7	−3.2	8	30
1979	−1.7	−2.9	21	92
1980	−0.7	−2.6	24	101
1981 [a]	0.1	−1.3	26	148
Romania				
1971	−0.2	−0.3	1	33
1975	−0.1	−0.3	3	23
1979	−1.2	−1.7	7	22
1980 [a]	−1.5	−2.4	9	25
1981 [a]	0.2	−0.8	10	32

[a] Preliminary estimates.

[redacted]

Economic Performance by Country

Bulgaria. Bulgaria chalked up impressive growth rates in the first half of the 1970s as it continued a fast-paced industrialization program. Starting in 1974, Sofia undertook an import spending spree in the West that resulted in a rapid increase in its hard currency debt by 1978. In 1979 Bulgaria embarked on a program to deal with its balance-of-payments and debt problems. Sofia was able to improve its trade position dramatically by boosting exports to developing countries, and by obtaining crude oil through barter and soft currency arrangements and reexporting some of it to the West as crude and products. [redacted]

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Bulgaria has not neglected agriculture to the same extent as some of its neighbors. Although a poor grain harvest helped push GNP into a small absolute decline in 1980, near-record grain production last year paced a strong rebound for the economy as a whole. Nevertheless, labor scarcity, sluggish labor productivity, and inefficient central planning dim prospects for sustained strong performance over the next several years. Growing Soviet reluctance to supply Bulgaria's increasing raw material and energy needs may further impede growth. Aware of these problems, Sofia has recently stepped up discussion of its long-planned economic reform, but implementation in the near future seems unlikely. The plan targets for 1981-85 confirm the outlook for slower growth and indicate continued emphasis on heavy industry, although the consumer sector will reportedly receive more attention than in the past. [redacted] 25

Czechoslovakia. The Czechoslovak economy has performed poorly not because of irresponsible investment and import policies, but because of the leadership's deep-seated reluctance to borrow in the West. The price paid for Prague's caution is a highly obsolescent, inefficient industrial base. As a result, productivity is lagging, manufactured goods are not competitive on world markets, and transportation and energy bottlenecks are stifling economic activity. Indeed, the economy faces an increasingly severe energy crisis as domestic fuel production slows and Soviet deliveries stagnate and decline. [redacted] 25

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The economic slowdown is being felt increasingly by consumers who are facing worsening shortages and higher prices with little prospect of improvement in the next few years. This poses an especially difficult problem for Prague, which has tried to win political acceptance from its population since 1968 by delivering a relatively high standard of living. These developments have increased pressures for systemic reform; yet the "Set of Measures" [2] implemented in 1980 is unwieldy, often contradictory, and appears to be working poorly. Czechoslovakia's unhappy experience with political and economic liberalization in 1968 makes the leadership extremely cautious with respect to basic reform. [redacted] 25

East Germany. While growth of the East German economy has slowed in recent years from the high rates of the early 1970s, the GDR is still outpacing most of the other East European economies. Even though industry suffered losses of raw materials from Poland and energy shortages forced the closing of some plants, East Germany maintained GNP growth in the 2.5- to 3.0-percent range in 1981. At the cost of a large and rising external debt, East Berlin has sustained growth through high levels of investment and supportive policies for consumption. East Germany's performance has been aided materially by its special relationship with West Germany and by Moscow's tolerance of the GDR's massive trade deficits with the USSR. [redacted] 25

In contrast to Hungary's movement toward market mechanisms, East Germany is attempting to overcome the failings of Soviet-style central planning through administrative decentralization. Berlin has created decisionmaking bodies at lower levels where presumably they can gauge economic needs more effectively. The East German plan is to feed decisions made by these bodies through an elaborate computer network in the hope that advanced technology will weed out inefficiencies. [redacted] 25

[2] The *Set of Measures for the Improvement of the System of Planned Management of the National Economy After 1980*, enacted in 1980 and implemented on 1 January 1981, is a mild reform package that grew out of a series of economic "experiments" in the late 1970s. [redacted] 25

Although the GDR has avoided so far the balance-of-payments constraints suffered by the other East European economies, its mounting debt and the growing reluctance of Western banks to supply new credit—not to mention reduced availability of Soviet oil—will probably slow growth in the near future. Nevertheless, the East Germans have announced ambitious production goals for 1981-85 to be achieved via large gains in productivity. [redacted] 25

Hungary. Hungary stands apart from the rest of Eastern Europe in having linked its development strategy to export promotion. Over more than a decade, Budapest has proceeded sporadically to jettison those features of central planning most inimical to the development of internationally competitive industries. For the next several years, Hungary intends to subordinate growth to the need to maintain external balance. [redacted] 25

Hungary's movement away from the command economy prototype dates back to the introduction of economic reforms known as the New Economic Mechanism in 1968. The essential features of these reforms included limitations on the scope of central price determination and investment allocation; replacement of detailed plan directives with market-oriented regulators; and partial linking of foreign and domestic prices through more realistic exchange rates. Budapest, of course, retained key "brakes" to slow the transition to a more marketlike mechanism: absence of significant interenterprise competition; lack of effective competition from imports; and continued subsidization of unprofitable firms. The intention, however, was to remove these brakes over a fairly short period of time. [redacted] 25

After good overall economic performance in 1968-73, Budapest tightened central control in 1974-78, largely to shield the economy from external shocks—deteriorating terms of trade, sluggish export markets in the West, the rising cost of borrowed capital, and reduced growth in supplies of energy and raw materials from

the USSR. Moreover, Hungary's balance of payments had suffered from a tendency of enterprises to undertake excessive investments and inventory accumulation.[redacted]

Failure to bring the hard currency balance of payments under control in 1977-78 forced Budapest to take measures that slowed economic growth. Hungary's hard currency financial position then strengthened in 1979-81. In allocating resources, the top two priorities have become net exports and personal consumption, the latter dictated by political realities, with investment now coming in third. Investment declined absolutely in 1979-80 and is not expected to grow significantly in the next five years.[redacted]

Since growth of the capital stock and labor force will be nearly flat during the 1980s, the economy's performance will depend mainly on its ability to increase productivity of both capital and labor. At the same time, Budapest wants to improve the balance of payments by increasing exports. To attain these goals, Hungarian policymakers have resumed their program of basic reform. Domestic prices are being brought closer to world prices. State subsidies are to be phased out for most producers, and money-losing firms are to be liquidated or merged with profitable enterprises. To increase competition, a significant number of new firms have been established by breaking up large enterprises and trusts. Also, state-owned firms may now spin off privately owned subsidiaries, and Hungarian citizens may form small private companies.[redacted]

Hungary hopes that its domestic austerity and reform measures will help the economy move toward an export surplus and that hard currency debt will grow much more slowly. Bureaucratic resistance to reform, new external shocks, and consumer pressures may well frustrate attainment of this goal. Recent cutbacks in Western bank lending have jeopardized Hungary's financial health. Nevertheless, Budapest's impending admission to the International Monetary Fund can probably provide a reasonably secure safety net for Hungary's external finances over the medium term.[redacted]

As a result of the redoubled export effort, Budapest projects that the standard of living will improve little during 1981-85, while money incomes will rise. This is an important reason for allowing greater private ownership, investment, and entrepreneurial activities, which Budapest anticipates will improve the supply of consumer goods and services while providing a new 25
outlet for savings.[redacted] 25

Poland. The causes of the Polish economic tailspin—a roughly 14-percent decline in GNP in 1981 following a 4-percent fall in 1979-80—go far beyond labor unrest and the endemic inefficiencies of centrally planned economies. While Poland's economic mechanism differs little from that of the other East European countries, its planning and management have been exceptionally poor.[redacted] 25
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The first half of the 1970s witnessed an almost indiscriminate expansion of industrial capacity, partly financed by Western credit. Little thought was given to how hard currency debts would be repaid as poor investment decisions sank resources into outmoded technology and into sectors in which Poland has no competitive advantage. Furthermore, Warsaw shortchanged the agricultural sector while trying to pacify the industrial labor force with rising money incomes and heavy subsidization of consumption. Underinvestment, poor incentives, bureaucratic interference, and several years of unfavorable weather depressed food production. With subsidized prices encouraging consumers to demand more high-quality food, Poland had to import substantial quantities of grain.[redacted] 25

Until the late 1970s, the Polish leadership could 25
whitewash its errors by continuing to borrow heavily in the West. Since 1979 Poland has been maneuvering desperately to avoid a formal default. Warsaw has cut imports, even of some critical items, and has pushed exports, more and more by diverting goods from domestic use. This effort has caused worsening problems in industry, agriculture, transportation, and consumer supply, as well as rapidly spreading underutilization of productive capacity.[redacted] 25

Before the imposition of martial law, Warsaw expected a continued decline in national income in 1982. A
clear picture of worker productivity since martial law 25

was declared has yet to emerge, but gains from the longer workweek are likely to be eroded by shortages of Western materials and passive resistance. Even under the best of circumstances, economic activity will not regain 1978 levels for several years. A long-term, sustained economic recovery can be achieved only by resolution of Poland's debt crisis and by a program of basic reform that the party and a majority of the workers and peasants are willing to accept. [redacted]

Romania. After nearly two decades of strong growth, Romania's economic performance has been weakening steadily since 1978, and there is little prospect of a quick turnaround. Romania's slowdown stems from accumulated planning errors, mismanagement, and tightening balance-of-payments constraints. A bloated bureaucracy has imposed an excessively rigid system of central planning with inadequate incentives for workers and managers. Industrial production has been hampered by energy shortages and cutbacks in hard currency imports of raw materials and technology. [redacted]

The two areas suffering the most severe problems are agriculture and energy. Investment in agriculture has long been slighted in favor of heavy industry, and migration has left an aged and unproductive farm labor force. Worsening food shortages and sporadic unrest forced the regime to institute rationing of some food items in 1981. While Bucharest recently announced long-promised measures to increase investment and production incentives for agriculture, output and consumer supply are unlikely to improve substantially in the short run. [redacted]

Romania has experienced continuing shortfalls in domestic energy production because its reserves are being rapidly depleted. This places a growing strain on the economy, since Romania's industrial plant is a very inefficient user of energy and Bucharest has based its export plans largely on the petrochemical industry. To meet rising domestic demand while maintaining refined product exports, Romania has become in recent years a substantial importer of crude oil. The cost of these imports has contributed to the serious deterioration in Romania's balance of payments and pushed Bucharest to current negotiations on rescheduling its hard currency debt. [redacted] 25

Outlook

Eastern Europe's economic slump shows no sign of abating. The forces depressing growth since the late 1970s have, if anything, grown stronger; continuing turmoil in Poland compounds these problems. East European leaders frankly acknowledge the seriousness of their economic position and warn of stagnation in living standards—a worrisome prospect because it could have serious political repercussions. According- 25
ly, in the face of slow growth projected in 1981-85 plans, most countries have trimmed back investment rates to free up more resources for consumption and net exports. [redacted] 25

East European economic performance will continue to sag:

- In all of the countries except Romania, the rate of increase in the labor force will decline in 1981-85.

- Modernization of industrial plant will lag since competing consumer demands and balance-of-pay- 25
ments constraints are prompting governments to cut investment to the bone. The inefficiency of Eastern Europe's capital stock becomes increasingly burdensome as supplies of cheap energy and raw materials wane.

- Productivity growth shows no sign of picking up in the 1980s; stagnating per capita consumption levels will tend to depress labor effort, while sluggish investment and reduced imports of Western machinery will leave the capital-labor ratio little changed and will hobble technical progress. [redacted] 25

Tightening external constraints will limit the inflow of resources from the USSR and the West that have helped Eastern Europe offset internal shortcomings:

- Reductions in 1982 concessionary Soviet oil deliveries to Czechoslovakia, the GDR, and Hungary threaten to bring their economic growth to a halt. While billed as a one-year cutback, Moscow's action probably heralds a permanent reduction in oil and raw material deliveries. At a minimum, Soviet

domestic shortfalls will prevent the USSR from increasing exports of materials and energy at past rates. Eastern Europe cannot afford to offset inadequate Soviet supplies through purchases on the world market.

- East European terms of trade with both the USSR and the West are likely to worsen as CEMA pricing adjusts to 1979-80 world energy price increases while prices of Western capital goods continue to rise.

- The chillier East-West political climate as well as Poland's and Romania's financial problems is deterring Western lenders from increasing their exposure to Eastern Europe. Since new lending will at best be little greater than debt service obligations, hard currency import capacity will be tied tightly to export performance.

- Slow growth in the West and possibly heightened protectionism will frustrate Eastern Europe's plans to raise appreciably the volume of exports to hard currency countries; the USSR, in turn, will probably demand more imports of East European goods otherwise salable in the West. [redacted]

The crisis in Poland further darkens the economic prospects for the rest of Eastern Europe. Although the evidence is unclear, the USSR may be diverting to Poland deliveries of raw materials originally intended for other East European countries. Moscow is pressing the other Warsaw Pact allies into giving aid, especially scarce consumer goods, to the Poles. Poland's failure to meet its CEMA trade commitments—particularly coal for the GDR—further complicates the fulfillment of East European plans. [redacted]

Prospects for Economic Reform

The distortions and inflexibility of centralized planning compound the internal and external troubles besetting the East European economies. Although some East European leaders recognize the inefficiency of their economic systems, any inclination toward reform will probably be limited for the foreseeable future. The danger of incurring the wrath of reform opponents, particularly in Moscow, is considerable. Furthermore, in return for uncertain long-run benefits, reform promises painful short-run costs for the domestic population—higher consumer prices, unemployment, less egalitarian income distribution. In addition, reforms that give more play to market forces would meet with resistance from the politically entrenched bureaucracy, who would lose some of their power and control over economic decisionmaking. Politically, the emphasis in most of Eastern Europe at this point in the Polish crisis is on tightening central controls, not on relaxing them. [redacted] 25

The crisis in Poland has intensified the dilemma East European governments face in addressing their basic economic ills while trying to provide a steady rise in per capita consumption. Although discontent in the other East European countries is far from being as high as it was in Poland, all East European regimes know they must pay attention to consumer needs in order to avoid the Polish experience. Their 1981-85 plans were delayed and revised as governments sought to maintain consumption levels and to balance external accounts in a period of economic stagnation. Whereas most East European regimes imposed steep consumer price increases in 1979, the Polish crisis 25
seemingly deterred new rounds of price adjustments in 1980-81. Governments began to increase food subsidies again and appeared prepared to hold the line on prices in general. [redacted] 25

Eastern Europe hopes that luck and ad hoc adjustments will see it through the coming lean years. Continued domestic shortages and hard currency import stringencies probably is prodding the East European planners to hike consumer prices in 1982, but comprehensive reform packages seem out of the 25
question for the next few years. Only Hungary apparently remains intent on giving a greater role to market forces. [redacted] 25